

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE SOUTHERN DISTRICT OF ILLINOIS

IN RE: )  
)  
SCOTT E. LUSTER and ) Bankruptcy Case No. 00-31005  
PHYLLIS LUSTER, )  
SCOTT LUSTER ENTERPRISES) )  
)  
Debtors. )

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HEPTACORE, INC., )  
)  
)  
Plaintiff, )  
)  
vs. ) Adversary Case No. 00-3191  
)  
SCOTT E. LUSTER, )  
)  
Defendant. )  
**and**

IN RE: )  
)  
BRADLEY A. NEFF, ) Bankruptcy Case No. 00-11184  
)  
Debtor. )

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HEPTACORE, INC., )  
)  
)  
Plaintiff, )  
)  
vs. ) Adversary Case No. 00-3339  
)  
BRADLEY A. NEFF, )  
)  
Defendant. )

OPINION

These consolidated matters having come before the Court for trial  
on a Complaint objecting to discharge of debt; the Court, having heard

sworn testimony and arguments of counsel and being otherwise fully advised in the premises, makes the following findings of fact and conclusions of law pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure.

#### Findings of Fact

As noted above, these two adversary proceedings were consolidated for the purposes of trial, as they arise from a single set of operative facts. The Plaintiff, Heptacore, Inc., has filed a Complaint seeking to have a debt in the amount of \$678,000 declared non-dischargeable in the bankruptcies of both Scott E. Luster and Bradley A. Neff under the provisions of 11 U.S.C. § 523(a)(2)(A) and 11 U.S.C. § 523(a)(4). The debt in question is based upon an Agreement for Extension of Credit and Security Agreement entered into between the Plaintiff Corporation and a corporation known as Cash Flow Management, Inc., which was owned and operated by the Defendants, Scott E. Luster and Bradley A. Neff. The line of credit between the Plaintiff and Cash Flow Management, Inc. was additionally personally guaranteed by the Defendants.

The Plaintiff Corporation is a holding company owned and operated by the Drury family located in Bloomsdale, Missouri. Heptacore, Inc. was formed by the Drury family in June 1992, as an investment holding company through which the shareholders (members of the Drury family) could diversify their investments outside of their original company known as Bloomsdale Excavating Company, Inc. Wayne Drury testified on

behalf of the Plaintiff that the Drury family first became acquainted with the Defendants in the 1980s, when they utilized the services of the Defendants' brokerage company, known as Rate Search, Inc. The uncontroverted evidence indicates that, during the 1980s, the Drury family, through Bloomsdale Excavating Company, Inc., invested various sums of money with the Defendants and their company, Rate Search, Inc., which was in the business of locating high yield certificates of deposit for investment. Wayne Drury testified that the relationship between his family and their related companies and Rate Search, Inc. was good, and that the investments made through Rate Search, Inc. were successful. Sometime during the late 1980s, into the early 1990s, the Drury family ceased investing money through Rate Search, Inc., mostly as a result of the dropping interest rates on certificates of deposit.

As a result of the dropping interest rates on certificates of deposit, Defendant, Scott E. Luster, testified that the business of Rate Search, Inc. began to suffer in the early 1990s, and the Defendants began to explore new business opportunities at that time. The Defendants became aware of the potential for making significant income in the factoring industry through a client of Rate Search, Inc., and decided to try their hand at factoring. In furtherance of this decision, both Defendants, Scott E. Luster and Bradley A. Neff, attended a week-long seminar on factoring, and formed a corporation known as Cash Flow Management, Inc. to conduct the business of

factoring.<sup>1</sup>

Having established Cash Flow Management, Inc., the Defendants found that they required capital investment in the newly formed corporation to provide sums with which to purchase accounts receivable to begin factoring. The evidence indicates that, in November 1994, Defendant, Scott E. Luster, contacted Wayne Drury concerning the possibility of the Drury family investing in Cash Flow Management, Inc. In December 1994, or early January 1995, Defendants, Scott E. Luster and Bradley A. Neff, traveled to Bloomsdale, Missouri, and made a presentation to the Drury family regarding the factoring company which they had formed. This presentation led to an Agreement for Extension of Credit and Security Agreement, whereby the Plaintiff Corporation, Heptacore, Inc., agreed to extend credit on a credit line to Cash Flow Management, Inc. in an amount up to \$500,000 in the form of periodic advances, to be used for the sole purpose of factoring accounts receivable. As a condition of the Agreement for Extension of Credit and Security Agreement, both Defendants, Scott E. Luster and Bradley A. Neff, personally guaranteed the repayment of all sums loaned to Cash Flow Management, Inc. Wayne Drury testified that the Agreement for Extension of Credit and Security Agreement would not have been executed

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<sup>1</sup> Factoring involves the purchase of another company's accounts receivable for a discounted cash figure, thus providing that company with immediate cash flow while providing the factoring company with the opportunity to generate income by collecting the accounts receivable for their face value and charging for that collection an amount based upon the time required to collect said account receivable.

by the Plaintiff Corporation without the personal guarantees of the Defendants, as he wanted the Defendants to be personally tied to the obligation in order that they would use their best efforts to ensure the success of the relationship.

The evidence adduced at trial indicates that, early in 1995, Cash Flow Management, Inc. began to draw on the \$500,000 credit line to purchase accounts receivable for factoring. Throughout 1995, it is apparent that the business of Cash Flow Management, Inc. went well, and that the Plaintiff Corporation was paid not only the interest due under the Agreement for Extension of Credit and Security Agreement, but was also repaid a substantial portion of the principal indebtedness.

Sometime in October 1995, Cash Flow Management, Inc. made the first of several requests to the Plaintiffs for extension of credit to factor accounts receivable for a drug testing company known as Occupational Health Associates, Ltd. The evidence indicates that the Plaintiff did extend the credit requested, and, by the end of 1995, the entire \$500,000 credit line had been exhausted. During the period of November through December 1995, Defendant, Scott E. Luster, became a member of the board of directors of Occupational Health Associates, Ltd. and also became chairman of the board of directors of that company in December 1995. This relationship was not made known to the Drury family until sometime in September 1996.

In January 1996, having exhausted the entire \$500,000 line of

credit under the original agreement for extension of credit, Defendant, Scott E. Luster, attended a shareholders' meeting of the Plaintiff Corporation. Defendant proposed that the Plaintiff's \$500,000 extension of credit be converted to equity in Cash Flow Management, Inc., and that a new line of credit be established in the amount of \$1,000,000. The Plaintiff was not agreeable to the Defendant's proposal, but did agree to increase the line of credit to \$700,000 in a letter agreement that was reduced to writing and fully executed by an Amendment to Agreement for Extension of Credit and Security Agreement, dated July 3, 1996. At about the same time as negotiations for an increased line of credit between Cash Flow Management, Inc. and Heptacore, Inc. were occurring, the Defendants formed a new corporation known as Industrial Health Associates, Ltd., a Missouri corporation, which was formed to perform drug testing in Missouri, modeled after Occupational Health Associates, Ltd., of which Scott E. Luster was Chairman of the Board of Directors. The evidence indicates that none of the corporations which the Defendants were involved in followed corporate formalities, in that no stock certificates were issued, no corporate minutes were kept, and there were few, if any, shareholders' meetings held. The evidence further indicates that Defendant, Scott E. Luster, was the President of Rate Search, Inc., Industrial Health Associates, Ltd., and, later, Occupational Health Associates, Ltd.; and that Defendant, Bradley A. Neff, was a Vice President in those

corporations. Scott E. Luster was the controlling shareholder in Rate Search, Inc., Cash Flow Management, Inc., Industrial Health Associates, Ltd., and, later, Occupational Health Associates, Ltd.; while Bradley A. Neff held a minority interest in those organizations. Scott E. Luster testified that he was the sole director of Rate Search, Inc., Cash Flow Management, Inc., and Industrial Health Associates, Ltd.

Although the business of Cash Flow Management, Inc. appeared to do well throughout the year of 1995, its fortunes began to change in 1996. After the formation of Industrial Health Associates, Ltd., it became obvious that capital investment was needed for that company for start-up expenses. Rather than seeking investment monies through other sources, Defendant, Scott E. Luster, authorized a series of requests for extension of credit from the Plaintiff Corporation to Cash Flow Management, Inc., requesting funding for factoring of various accounts receivable. The evidence indicates that certain accounts receivable of the company known as Occupational Health Associates, Ltd. were mislabeled as accounts receivable for the company known as Industrial Health Associates, Ltd., and that other accounts receivable were misidentified. This resulted in a series of extensions of credit from the Plaintiff to Cash Flow Management, Inc., which ultimately resulted in an extension of credit in the amount of \$80,000. All of which was used as venture capital for the company known as Industrial Health Associates, Ltd., rather than being used to factor accounts receivable,

as indicated in the request for extension of credit.

On May 13, 1996, Plaintiff Corporation was telefaxed a request for extension of credit on Cash Flow Management, Inc. letterhead, requesting \$50,000 for funding needed for continued business related to three clients of Cash Flow Management, Inc.: Quality Paints, Inc., Occupational Health Services, Ltd., and Plane Detail, Inc. Pursuant to this request, on May 15, 1996, the Plaintiff wire transferred the sum of \$50,000 to the factoring funding account of Cash Flow Management, Inc. The evidence clearly indicates that this \$50,000 was not used for the factoring of accounts receivable, but, through various transfers, found its way to the personal checking account of Scott E. Luster. On May 15, 1996, Defendant, Scott E. Luster, issued a check on his personal account in the amount of \$50,000, payable to a gentlemen by the name of David Greenwell, as a down payment for purchase of the stock in a company known as Occupational Health Associates, Ltd. under an additional share procurement agreement dated May 15, 1996. In this agreement, Scott E. Luster agreed to purchase all of the remaining shares of Occupational Health Associates, Ltd. from David Greenwell. The evidence also indicates that an additional \$5,000 of monies loaned by the Plaintiff to Cash Flow Management, Inc., for the purpose of factoring, was used not for that purpose, but for the repayment of a loan made to Cash Flow Management, Inc. by the corporate entity known as Rate Search, Inc.



Defendant, Scott E. Luster, testified that the purchase of Occupational Health Associates, Ltd. and the formation of Industrial Health Associates, Ltd. were premised upon a belief that ownership of the companies for which Cash Flow Management, Inc. factored accounts would create a relationship that would ensure that the accounts receivable were collectible, and that less investigation as to the validity of the accounts would be required given the control over the company generating the accounts. This premise proved to be faulty, in that the business of Cash Flow Management, Inc. faltered badly during the year of 1996. Defendant, Scott E. Luster, claims that many of the accounts receivable purchased from Occupational Health Associates, Ltd. and its previous owner, David Greenwell, were bogus and uncollectible. As a result, Cash Flow Management, Inc. found itself in serious financial trouble with the entire \$700,000 line of credit from Plaintiff being exhausted by September 1996. This claim is not substantiated by the evidence.

In September 1996, after the Plaintiff Corporation had advanced the total amount available in its line of credit (\$700,000), Defendant, Scott E. Luster, called a meeting with Plaintiff's president, Wayne Drury, to inform Mr. Drury that Cash Flow Management, Inc. could not repay the loan. Shortly thereafter, Cash Flow Management, Inc. defaulted on its loan to the Plaintiff, leaving a balance of \$678,000 on the loan at that time. It was not until the meeting between Scott

E. Luster and Wayne Drury, in September 1996, that the Defendant's ownership and control of Occupational Health Associates, Ltd. and Industrial Health Associates, Ltd. was disclosed. Wayne Drury testified that, had he known of the involvement of Scott E. Luster in these companies, the credit line would not have been increased, and no further monies would have been extended.

In addition to the clear evidence that \$135,000 was extended to Cash Flow Management, Inc. during 1996, and used for purposes other than factoring, Defendant, Scott E. Luster, testified at his first meeting of creditors in his underlying bankruptcy case that \$150,000 of the line of credit from Plaintiff was used in winding up the affairs of Cash Flow Management, Inc., rather than for factoring accounts receivable. This testimony has been uncontroverted and was not denied at trial in this matter.

#### Conclusions of Law

During the course of trial in this matter, the Plaintiff objected to the admissibility of Defendants' Exhibits C, D, E, F, and H. The Plaintiff argued that the Defendants' exhibits were inadmissible as hearsay under Federal Rules of Evidence 801 and 802, made applicable in this adversary proceeding by Federal Rule of Bankruptcy Procedure 9017. At the close of trial, the Court requested that the parties brief the issue of admissibility of these exhibits. In their closing arguments, the parties have so argued. In reviewing the arguments of the parties

as to admissibility of Exhibits C, D, E, F, and H, the Court finds that the exhibits should be admitted, over the objection of the Plaintiff, as exceptions to the hearsay rule, in that they tend to show the state of mind of Cash Flow Management, Inc.'s principals during the summer of 1996.

Pursuant to 11 U.S.C. § 523(a)(4):

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt - . . .

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

The term "fiduciary" as used in § 523(a)(4) requires the existence of an express or technical trust as opposed to an implied trust arising by operation of law as a matter of equity. In re Hodges, 115 B.R. 152 (Bankr. S.D. Ill. 1990). In order to prove non-dischargeability under § 523(a)(4), a plaintiff must prove by a preponderance of the evidence that: (1) an express trust existed; (2) the debt was caused by fraud or defalcation; and (3) the debtor acted as a fiduciary to the creditor at the time the debt was created. See: In re Hodges, supra, at 155; and In re Marchiando, 13 F.3d 1111 (7th Cir. 1994). A plaintiff has the burden of proof by a preponderance of the evidence. Grogan v. Garner, 111 S.Ct. 654, 498 U.S. 279 (1991). In examining the facts of this case under 11 U.S.C. § 523(a)(4), the Court must conclude that the Plaintiff has failed to meet its burden of proof in that there is no express trust between the parties, and there has been no showing that

either of the Defendants acted in a fiduciary capacity as to the Plaintiff. The Court finds that the facts of this case show that there was a typical debtor/creditor relationship between the parties; and, further, that there has been no showing of any embezzlement or larceny, as those terms are terms are defined in the case law. See: In re Weber, 892 F.2d 534 (7th Cir. 1989); U. S. Life Title Ins. Co. of New York v. Dohm, 19 B.R. 134 (D.C. N.D. Ill. 1982); and In re Iaquinta, 95 B.R. 576 (Bankr. N.D. Ill. 1989).

In order to establish non-dischargeability of a debt under 11 U.S.C. § 523(a)(2)(A), a creditor must prove: (1) that the debtor made a materially false representation; (2) that the debtor knew the representation was false when he or she made it, or the representation was made with such reckless disregard for the truth as to constitute willful misrepresentation; (3) that the debtor made the false representation with the intention and purpose of deceiving the creditor; (4) that the creditor justifiably relied on the false representation; and (5) that the creditor sustained damages as a proximate result of reliance on the false representation. In re Scarlotta, 979 F.2d 521 (7th Cir. 1992); and Field v. Mans, 516 U.S. 59, 116 S.Ct. 437 (1995). Here again, the plaintiff has the burden of proof by a preponderance of the evidence under the authority of Grogan v. Garner, supra. In reviewing the facts of this case as to the Defendant, Bradley A. Neff, under the elements of 11 U.S.C. §

523(a)(2)(A), the Court concludes that the Plaintiff has failed to meet its burden of proof in showing that Bradley A. Neff made any materially false representations and that Bradley A. Neff had the intent and purpose to deceive the Plaintiff. The evidence is clear that the Defendant, Scott E. Luster, was the driving force behind the corporations controlled by the Defendants; and that, even though Defendant, Bradley A. Neff, was Vice President of Rate Search, Inc., Cash Flow Management, Inc., and Industrial Health Associates, Ltd., it was clear that he functioned more as an employee rather a decision maker. There is no evidence that, other than a salary which he was paid, the Defendant, Bradley A. Neff, wrongfully received any of the monies loaned by the Plaintiff, nor was there any direct evidence that the Defendant, Bradley A. Neff, was even aware of the exact nature of the transactions between the Plaintiff and Cash Flow Management, Inc. For these reasons, the Court must conclude that the Plaintiff's Complaint as against the Defendant, Bradley A. Neff, must be denied under both 11 U.S.C. § 523(a)(2)(A) and § 523(a)(4). The Court further concludes that Defendant, Bradley A. Neff, should be discharged in bankruptcy under 11 U.S.C. § 727, as to his personal guarantee of the indebtedness to Plaintiff, Heptacore, Inc.

In examining the facts of this case as to the Defendant, Scott E. Luster, the Court finds that, while the Plaintiff has failed to show that the entire transaction between the Plaintiff and Defendant was

fraudulent under 11 U.S.C. § 523(a)(2)(A), the Plaintiff has shown, by a preponderance of the evidence, that there were instances of fraud in the transaction and that this fraud was perpetrated by the Defendant, Scott E. Luster. These instances include a \$50,000 purchase of stock in Occupational Health Associates, Ltd. with Plaintiff's funds that should have been used to factor accounts receivable; the \$80,000 used as start-up capital for Industrial Health Associates, Ltd., which was obtained by the mislabeling of accounts receivable; the \$5,000 that was used to repay a loan to Rate Search, Inc. from Cash Flow Management, Inc.; and the \$150,000 of Plaintiff's monies spent on wind-up affairs of Cash Flow Management, Inc. rather than on factoring accounts receivable as required by the loan agreement between the parties. The Court finds that Defendant, Scott E. Luster, was directly responsible for the misrepresentations made in obtaining these funds, and that he was also directly responsible for failing to disclose material information to the Plaintiff concerning his involvement in Occupational Health Associates, Ltd. and Industrial Health Associates, Ltd. The Court finds that the actions taken by Scott E. Luster, as to both Occupational Health Associates, Ltd. and Industrial Health Associates, Ltd., were material actions that should have been disclosed to the Plaintiff, as having a bearing on the Plaintiff's decision to loan monies on the line of credit between the parties. In reaching this conclusion, the Court found that the testimony of Plaintiff's witness,

Wayne Drury, was credible and that the testimony of the Defendant, Scott E. Luster, was not credible.

In addition to finding that the Plaintiff is entitled to monetary damages in the amount of \$285,000 from Defendant, Scott E. Luster, for fraudulently obtaining funds from the Plaintiff as outlined above, the Court also concludes that, pursuant to the loan agreement between the parties and the personal guarantee of Defendant, Scott E. Luster, the Plaintiff is entitled to collect attorney's fees in this action. In this regard, the Court has reviewed the Plaintiff's request for attorney's fees embodied in Plaintiff's Exhibit No. 29. Based upon this exhibit, the Court finds that the Plaintiff should be awarded attorney's fees, as requested, in the amount of \$14,170.88, as against the Defendant, Scott E. Luster. The total judgment, under 11 U.S.C. § 523(a)(2)(A), is \$299,170.88.

ENTERED: **June 14, 2001.**

/s/ GERALD D. FINES  
United States Bankruptcy Judge